

## Message Text

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ACTION ARA-10

INFO OCT-01 ISO-00 ARAE-00 SP-02 AID-05 EB-07 NSC-05

CIEP-01 TRSE-00 SS-15 STR-04 OMB-01 CEA-01 CIAE-00

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P R 031450Z JUN 75

FM AMEMBASSY LIMA

TO SECSTATE WASHDC PRIORITY 5367

INFO AMEMBASSY SANTIAGO

C O N F I D E N T I A L LIMA 4473

EO 11652: GDS

TAGS: PINT, ECON, EINV, PGOV, PE

SUBJ: PRIME MINISTER MORALES BERMUDEZ PRESAGES MAJOR  
ECONOMIC POLICY SHIFT ON SUBSIDIES AND PRICES

REFS: LIMA 4375, LIMA 2377, LIMA 2516 (ALL NOTAL)

1. IN AN AIRPORT PRESS CONFERENCE MAY 28, PRIME MINISTER MORALES BERMUDEZ ANNOUNCED THAT PERU WILL SOON CHANGE ITS POLICY OF MASSIVE GOVERNMENT SUBSIDIES ON ESSENTIAL AGRICULTURAL AND PETROLEUM PRODUCTS, A POLICY WHICH HAS BEEN IN EFFECT SINCE THE FIRST MONTHS OF THE REVOLUTION. THE PRIME MINISTER SAID THAT THE GOP MUST READJUST ITS ECONOMY AND DEVELOP AN EFFECTIVE WAGE AND PRICE POLICY WHICH WILL TAKE INTO ACCOUNT THE EFFECTS OF WORLD INFLATION, WHILE MAINTAINING THE PURCHASING POWER OF THE PERUVIAN WORKER.

2. THE PRIME MINISTER ANNOUNCED EXACT FIGURES (HERETOFORE UNAVAILABLE) FOR DIRECT SUBSIDIES WHICH AMOUNT TO S/12 BILLION (\$276 MILLION) AND INDIRECT SUBSIDIES OF  
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S/5 BILLION (\$115 MILLION). IT IS NOT CLEAR WHETHER

THESE REFERENCES ARE TO PREVIOUS 1973-74 BIENNIAL BUDGET DEFICIT OR CURRENT ESTIMATED DEFICIT FOR 1975-76. IN ANY CASE, THIS TOTAL REPRESENTS OVER ONE-HALF OF THE \$680 MILLION 1973-74 BIENNIAL BUDGET DEFICIT.

3. THE PRIME MINISTER ALSO MENTIONED THAT IN ORDER TO CARRY OUT PERU'S DEVELOPMENT PROGRAM THERE MUST BE SIGNIFICANT INCREASES IN PRIVATE SECTOR SAVINGS. TO STIMULATE ADDITIONAL SAVINGS, HE SAID CHANGES WILL BE MADE IN THE INTEREST RATES CURRENTLY PAID, WHICH ARE PRESENTLY NEGATIVE IN REAL TERMS.

4. AT THE AIRPORT EARLIER THIS SAME DAY, MINISTER OF TRANSPORTATION AND COMMUNICATIONS GENERAL MENESES ARATA NOTED THAT THE GOP WILL ANNOUNCE A PRICE INCREASE FOR PETROLEUM PRODUCTS BY JULY 28, PERUVIAN INDEPENDENCE DAY. HE GAVE NO INDICATION OF THE NATURE OF THIS INCREASE. (NOTE: THIS IS FIRST CLEAR INDICATION THAT A PRICE INCREASE IS PLANNED, AS WELL AS POSSIBLY RAISING THE VEHICULAR TAX, SEE LIMA 4375.)

5. COMMENT: MORALES BERMUDEZ' PUBLIC ANNOUNCEMENT OF A BASIC REDUCTION IN (AND IN SOME CASES THE POSSIBLE ABANDONMENT OF) SUBSIDIES AMOUNTS TO A SIGNIFICANT REVERSAL OF PRESIDENT VELASCO'S NEAR SACROSANCT POLICY OF KEEPING THE POTENTIALLY VOLATILE URBAN DWELLERS QUIESCENT THROUGH MASSIVE SUBSIDIES OF ESSENTIAL GOODS. FOOD AND PETROLEUM SUBSIDIES HAVE BEEN A MAINSTAY OF PERUVIAN POLITICO-ECONOMIC POLICY SINCE THE 1968 REVOLUTION. SOME SUBSIDIES ON SPECIFIC FOOD PRODUCTS HAVE ALREADY BEEN REDUCED, AND WE PRESUME THAT OTHERS WILL BE PHASED DOWN (OR OUT) SLOWLY TO REDUCE THE IMMEDIATE IMPACT. IN THIS REGARD, THE PETROLEUM SUBSIDY STANDS OUT AS THE POLITICALLY MOST IMPORTANT, SINCE IT WOULD AFFECT THE VITAL TRANSPORTATION SECTOR AND HAS ALSO SERVED AS THE SYMBOL OF GOP'S SUBSIDY APPROACH. BOTH THE IMF AND WORLD BANK HAVE RECOMMENDED A REDUCTION IN SUBSIDIES DURING THE LAST SIX MONTHS, WITH THE QUIET SUPPORT OF THE TECHNICAL LEVEL OFFICIALS IN THE MINISTRY OF FINANCE AND THE CENTRAL BANK. IT NOW APPEARS THAT MORALES BERMUDEZ

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HAS NOT ONLY ACCEPTED THEIR ADVICE (WHICH HE PROBABLY HAS FAVORED PERSONALLY SINCE HIS TERM AS FINANCE MINISTER), BUT HE NOW FEELS SECURE ENOUGH TO ANNOUNCE SUCH MEASURES PUBLICLY, PRESUMABLY WITH THE SUPPORT OF THE CABINET AND THE TACIT AND POSSIBLY GRUDGING ACCEPTANCE, IF THAT, OF PRESIDENT VELASCO. NONETHELESS, THIS ANNOUNCEMENT REPRESENTS AN IMPORTANT AND VISIBLE POLITICAL SHIFT AWAY FROM VELASCO'S POLICY IN THIS FIELD. WE PRESUME

THAT IT HAS TAKEN THE PRIME MINISTER SEVERAL MONTHS TO CONSOLIDATE SUPPORT FOR THESE MOVES, SINCE THE IMF AND WORLD BANK EXPERTS AND FINANCE MINISTRY OFFICIALS HAD EARLIER THOUGHT THAT A CHANGE IN SUBSIDY AND INTEREST RATE POLICY MIGHT BE ANNOUNCED AS EARLY AS MARCH.

6. IN ECONOMIC TERMS, THE REDUCTION IN SUBSIDIES WOULD BE THE FIRST OF A NUMBER OF STEPS TO DECREASE THE GROWING CENTRAL GOVERNMENT BUDGETARY DEFICIT AND CONSEQUENT INFLATION. ON THE OTHER SIDE, WAGE SETTLEMENTS AND SUBSEQUENT PRICE INCREASES COULD GENERATE A COST-PUSH COMPONENT TO INFLATION AND, POLITICALLY, COULD SERVE TO FURTHER INCREASE LABOR FORCE DISSATISFACTION. IN FACT, WE ALREADY HAVE SOME INDICATIONS THAT THE STRONG COMMUNIST TRADE UNION CONFEDERATION IS EXPERIENCING INCREASING INTERNAL PRESSURE TO REDUCE OR WITHDRAW ITS POLITICAL SUPPORT FROM THE GOP AND A REDUCTION IN SUBSIDIES WILL DO LITTLE TO ASSUAGE SUCH PRESSURES.

7. THIS PUBLIC DECISION TO REDUCE SUBSIDIES AND INCREASE INTEREST RATES IS A CLEAR INDICATION THAT MORALES BERMUDEZ INTENDS TO FOLLOW THE GENERALLY ORTHODOX MONETARY AND FISCAL POLICIES WHICH HE PURSUED AS FINANCE MINISTER. IT ALSO INDICATES THE PROBABLE STRENGTH OF HIS POLITICAL SUPPORT WITHIN THE ARMY, SINCE IT IS HIGHLY UNLIKELY THAT HE WOULD HAVE ANNOUNCED SUCH A SWEEPING POLICY CHANGE WITHOUT THE APPROVAL OF MOST OF HIS COLLEAGUES. THIS DECISION, HOWEVER, PROBABLY IS BASED ON A RATHER COLD ASSESSMENT BY THE PRIME MINISTER OF THE OVERALL ECONOMIC PROSPECTS FOR PERU AND THE NEED FOR BELT-TIGHTENING. IT SHOULD NOT BE INTERPRETED AS A CHANGE IN THE FUNDAMENTAL GOALS OF THE REVOLUTION, NOR OF A SLACKENING IN THE GOP'S DESIRE TO "RESTRUCTURE" THE

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PERUVIAN ECONOMY THROUGH BASIC CHANGES IN PROPERTY OWNERSHIP, INCOME REDISTRIBUTION SCHEMES, ETC. IN FACT, TWO DAYS AFTER THE PRIME MINISTER'S STATEMENT, THE GOP RELEASED THE DRAFT LAW, LONG RUMORED TO BE IN PREPARATION, SUGGESTING BASIC CHANGES IN THE INDUSTRIAL COMMUNITY CONCEPT WHICH WOULD STRENGTHEN THE HANDS OF THE COMMUNITY REPRESENTATIVES ON COMPANIES' BOARDS OF DIRECTORS AND ELIMINATE VARIOUS LOOPHOLES PRIVATE INDUSTRIAL ENTERPRISE HAS USED TO AVOID PAYING SHARES TO ITS WORKERS (SEE SEPTEL). THIS LAW IS OPEN FOR DEBATE IN THE NEXT SIXTY DAYS AND COULD YET UNDERGO CONSIDERABLE REVISION. IF THE NEW DRAFT LAW IS ENACTED, IT WILL PROBABLY FURTHER REDUCE WHAT LITTLE INCENTIVE THERE IS FOR PRIVATE DIRECT INVESTMENT. MORALES BERMUDEZ WILL HAVE HIS HANDS FULL TRYING TO AVOID KTMVP

OVA POLITICAL VICTIM FOR  
HIS NEW SUBSIDY POLICY, WHILE PUSHING COSTLY ECONOMIC  
SCHEMES AHEAD SUCH AS THE INDUSTRIAL COMMUNITY.  
DEAN

NOTE BY OC/T: LAST PARA AS RECEIVED. WILL BE SERVICED UPON REQUEST.

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